Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Developing a Unified Intercarrier Compensation Regime	)	CC Docket No. 01-92
	)	

COMMENTS OF SBC COMMUNICATIONS INC.

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SBC Communications Inc. (SBC) hereby submits its comments in response to the Commission's *Notice of Proposed Rulemaking* in this proceeding.[1] SBC has a vital interest in this proceeding as an incumbent local exchange carrier (ILEC), as a new entrant interexchange carrier (IXC), and as a competitive local exchange carrier (CLEC).

I. Introduction and Summary

SBC has been a firm proponent of bill and keep for Internet traffic, and it supports the Commission's proposal to extend bill and keep to all local, wireless and Internet telecommunications traffic that currently is subject to the Commission's reciprocal compensation rules. Such a bill-and-keep regime will rationalize and streamline inter-carrier relationships and is more in keeping with the pro-competitive, deregulatory world envisioned in the Telecommunications Act of 1996 (1996 Act) than the current reciprocal compensation scheme, which promotes inefficiency and arbitrage. SBC believes the Commission has the authority under the 1996 Act to implement such a regime, provided that it ensures there are end user recovery mechanisms.

The Commission also has proposed to replace interstate and intrastate access charges with bill and keep. That, too, has much to recommend it. The current complex

[1] *Developing a Unified Intercarrier Compensation Regime,* CC Docket No. 01-92, Notice of Proposed Rulemaking, Commission 01-132 (rel. April 27,2001) (*NPRM*).

system of intercarrier compensation rules, whereby different rules apply depending on the carrier and the nature of the traffic involved, is unsustainable over the long run and, like reciprocal compensation, also invites inefficiency and arbitrage. But replacing access charges with bill and keep is a much more difficult issue, and it is one that cannot be addressed solely as an intercarrier compensation issue. Access charges are critical to recovering the costs of local service attributable to interexchange traffic. If those costs are not recovered through carrier access charges, then they must be recovered through appropriate end user charges. The Commission *cannot* eliminate access charges without first ***ensuring*** that there are federal and state end user recovery mechanisms in place.

Before the Commission can implement a uniform bill and keep regime, it finally must tackle the difficult issues of implicit subsidies and universal service reform. Congress recognized that implicit subsidies would not be sustainable in the competitive environment created by the 1996 Act, so it required that all subsidies be explicit and that federal and state universal service mechanisms be "specific, predictable and sufficient."[2] Nevertheless, more than five years after the introduction of local competition, residential local service prices remain at levels that are not self-supporting, and federal and state regulators have failed to replace the vast majority of implicit subsidies with explicit recovery.

The pricing structure for residential local service discourages competitive entry in residential markets and necessitates implicit subsidies elsewhere (especially for multi-line urban businesses) that invite cream skimming and inefficient entry. It should not be

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[2] 47 C.F.R. § 254(b)(5).

surprising that competitors have "followed the money" -- flocking to the high-margin business market and largely ignoring the residential market. Nor should it be surprising that the implicit subsidies used to support below-cost residential service prices have been eroding rapidly, and that this erosion continues to accelerate due to competitive losses and arbitrage. The pro-competitive goals of the 1996 Act will never be fully realized until local residential prices rise to levels that are self-supporting and, therefore, attractive to competitors.

Fixing these implicit subsidy problems should be the Commission's first priority and should precede any implementation of a bill and keep structure that results in the elimination of carrier access charges. It is only after local residential prices are rationalized that the competitive and efficiency goals of a bill and keep structure can be realized.

Accordingly, SBC proposes a comprehensive reform plan that is comprised of three components. *First*, prior to implementing bill and keep, the Commission and the states must ensure that implicit subsidies are eliminated and replaced with explicit recovery. This involves both end user pricing reform and universal service support reform that establishes an affordability standard. ***Second,*** the Commission should adopt bill and keep rules that apply consistently to the exchange of all telecommunications traffic between a LEC network and another carrier's network (including rules addressing transport arrangements). The Commission also must establish a federal end user recovery mechanism and requirements for state end user recovery mechanisms. ***Third,*** the Commission should give all carriers pricing flexibility for wholesale and retail services. In a bill and keep environment, ILECs must have the same flexibility as other carriers to offer end users a range of calling plans at market-based prices so that they can respond to market forces.

The Commission has the authority, but also the obligation, to end the current reliance on implicit subsidies to maintain below-cost residential prices. Many of the universal service requirements of Section 254, including the requirement that universal service support be "specific, predictable and sufficient," apply at both the federal and state levels. In the recent *Qwest* **v.** *FCC* decision, the Tenth Circuit held that the Commission has an obligation to ensure that states take the necessary action to achieve the universal service requirements of Section 254.[3] On remand, the Commission must "develop mechanisms to induce adequate state action" to implement the statutory goals of universal service and to "explain further its complete plan for supporting universal service."[4] Since such reforms must *precede* any elimination of carrier access charges in favor of bill and keep, SBC urges the Commission to address implicit subsidies and universal service reform *immediately,* so that across-the-board bill and keep can be implemented by July 2005.

The Commission also has the authority to adopt a uniform bill and keep regime for both interstate and intrastate traffic. The Commission has plenary authority under Sections 201(g) and 201(b) to implement a bill and keep structure and establish an end user recovery mechanism for interstate access. With respect to intrastate access, the Commission has concluded that Section 251(b)(5) on its face applies to the transport and

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[3] *Qwest* **v.** *FCC,* Nos. 99-9546, 99-9947 and 00-9505,2001 U.S. App. LEXIS 17044 (10th Cir. July 31, 2001).

[4] *Id.* at *31, 34.

termination of ***all*** telecommunications traffic involving a LEC network. As the Commission has recognized, it has the authority under Sections 201(b), 251(d) and 251(i) to establish cost recovery rules as part of its implementation of Section 251(b)(5). A bill and keep structure is merely a set of cost recovery rules that changes the primary source of recovery for transport and termination from carriers to end users.

Moreover, a mandatory bill and keep regime appears to be consistent with the reciprocal compensation provisions of the Act, provided that the Commission ensures there are end user recovery mechanisms in place. Sections 251(b)(5) and 252(d)(2) require LECs to enter into arrangements that provide for the "mutual and reciprocal recovery of costs" for transporting and terminating traffic; these provisions do not require intercarrier compensation payments. SBC's bill and keep proposal establishes a framework that provides carriers with "mutual and reciprocal recovery of costs" (from either end users or other carriers), even in cases where traffic flows are not balanced.

SBC's comprehensive reform plan addresses many of the problems caused by the current intercarrier compensation regime and end user pricing rules. Resolving the problem of implicit subsidies would encourage competitive entry in all market segments. The gradual deregulation of pricing envisioned under SBC's plan would further benefit consumers by enabling all carriers to compete head-to-head in the market. The plan also would eliminate implicit subsidies and provide a specific, predictable and sufficient source of universal service funding. Further, under SBC's bill and keep proposal, carriers no longer would be able to generate huge reciprocal compensation payments by targeting customers with large amounts of incoming traffic, and new technologies such as IP telephony would have to compete with circuit-switched telephony on their own merits, rather than as arbitrage mechanisms. Finally, the plan resolves a number of difficult interconnection disputes that have arisen under the current rules.

II. Background

In order to evaluate how best to reform the current intercarrier compensation rules, it is helpful to review their history. For almost 100 years, federal and state regulators have relied on a "patchwork quilt" of implicit subsidies to ensure that every American has affordable access to the local telephone network. Maintaining a system based on implicit subsidies was relatively easy when telephone service was provided by a single monopoly provider (AT&T and its local subsidiaries) that could easily shift recovery among customers, services and geographic areas. For example, regulators used long-distance services to subsidize local services, business services to subsidize residential services, and services in urban areas to subsidize services in rural areas. In addition, interstate services subsidized local telephone services – the separations process eventually allocated 25 percent of local loop costs to the interstate rate base, even though long-distance calls accounted for a much lower percentage of line usage. In a monopoly environment, the fact that there was no correlation between price and cost for a particular service was immaterial. It was fairly easy to maintain a universal service system based on implicit subsidies, as long as AT&T was able to meet its revenue requirements and earn a reasonable return on investment.

The subsidizing of residential local telephone service became more complicated in the 1980s with the break-up of AT&T and the emergence of long-distance competition. Intercarrier compensation in the form of access charges paid by IXCs replaced the financial support previously provided by AT&T's long distance arm. The Commission also created new charges – a per-minute carrier common line (CCL) charge paid by long-distance carriers as part of access charges and a flat subscriber line charge (SLC) paid directly by end users – to recover the interstate portion of local loop costs.[5] To subsidize the provision of telephone service in rural areas, many interstate access charges were required to be averaged throughout each state and long-distance charges were required to be averaged throughout the nation. The Commission also created a high-cost loop fund to provide explicit support for intrastate loop costs in high-cost areas.[6]

State regulators also created a variety of implicit support mechanisms. **As** the Commission has recognized, state rate designs have provided implicit support flowing from (1) urban areas to rural areas, (2) business customers to residential customers, **(3)** vertical services to basic service, and (4) toll service to local service.[7] Further, the presence of this dual federal-state implicit subsidy regime has created arbitrage opportunities for customers, who can choose between interstate and intrastate rates for comparable access services. It also has prompted many large business customers to bypass the local telephone network entirely by deploying private networks or purchasing special access services.

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[5] For price cap LECs, the CCL charge was reduced in the Commission's *Access Charge Reform* proceeding and converted to the flat-rated presubscribed interexchange carrier charge (PICC), which usually is assessed on IXCs. Under the *CALLS Order*, single line PICCs were eliminated, and multi-line business PICCs and the CCL charge are being phased out and replaced with increases in the SLC and interstate access funding.

[6] Small rural carriers received the majority of high-cost loop fund support, as well as additional support for loops and switches from other federal assistance programs.

[7] *Federal-State Joint Board on Universal Service,* CC Docket No. 96-45, *Ninth Report and Order and Eighteenth Order on Reconsideration,* 14 FCC Rcd 20432,20441 (1999) *(Ninth Universal Service Order), aff'd in part, rev'd in part and remanded Qwest v. FCC,* 2001 U.S. App. LEXIS 17044.

The 1996 Act reshaped the foundation of the telecommunications market and, in the process, exacerbated many of the problems created by the complex system of price controls and implicit subsidies that were in place. As discussed in the following section, federal and state regulators have opened the local telephone markets to competition as required by the 1996 Act, but they generally have not addressed the problem of implicit subsidies. The result is that the ILECs' traditional sources of implicit support for below-cost residential local telephone service have been eroding rapidly, as competitors "cherry pick" business customers and bypass switched access charges. Moreover, the 1996 Act expanded the intercarrier compensation regime to include local telecommunications traffic, which has added to the complexity of the rules and created additional opportunities for regulatory arbitrage. Due to rapid changes in technology and the growth of the Internet, the current system has produced unintended arbitrage issues, such as multi-billion dollar reciprocal compensation payments for ISP traffic.

Today, much of the outdated system of implicit subsidies remains in place, even though the Commission has wrestled with access charge and universal service reform for the past five years. A universal service system based on implicit subsidies, however, is not sustainable or competitively neutral in the competitive environment created by the 1996 Act. The Commission appears to recognize the need for sweeping changes in the *NPRM*, but first and foremost it must recognize the need to address the critical issues of implicit subsidies and universal service reform. Below, SBC discusses some of the specific problems created by the current system and the need for comprehensive reform in this proceeding.

111. Problems With the Current Regulatory Regime

There are a number of regulatory failures that must be corrected as part of intercarrier compensation reform. Such failures generally can be categorized as market distortions caused by prices for residential local telephone service that are not self-supporting, the rapid erosion of implicit subsidies in the competitive environment created by the 1996 Act, various regulatory arbitrage problems created by the current patchwork of intercarrier compensation rules, and disputes involving the point of interconnection (POI) between networks. Each of these issues is discussed below.

A. Prices for Residential Local Service are Not Self-supporting

Before the Commission can implement a uniform bill and keep regime that shifts recovery from carrier access charges to end user charges, it must address the difficult issue of implementing pricing reform for residential local telephone service. The pro-competitive goals of the 1996 Act will never be realized until prices for residential local service are increased to levels that are self-supporting and, therefore, attractive to competitors. Many states have capped ILEC residential local prices without regard to the actual costs of providing service. In fact, prices for residential local service have not changed in more than ten years in some states, despite the fact that the cost structure of providing local service has been radically altered by factors such as the growth of Internet usage. Further, these prices are often the product of traditional intrastate ratemaking rules that relied upon residual pricing principles. This residual pricing methodology required prices for discretionary services such as vertical services, toll and switched access, as well as prices for some business services, to be set at artificially high levels so that residential local prices could be set below cost and still allow for overall recovery.

Moreover, some states have set residential prices according to the number of people in the local calling area, which produces the lowest prices in the highest-cost, lowest-density areas. The result is that ILEC regulated prices for residential services often bear no relation to the costs of providing service.

Given these types of regulated pricing structures, it should not be surprising that competitors have "followed the money" and flocked to toll and business service markets where the ILECs' regulated prices include implicit subsidies to support artificially low prices for residential local telephone services. **A** recent Commission report on the status of local telephone competition shows that competitors have successfully captured more than 20 percent of the market for medium and large businesses, institutional and government customers nationwide, while largely ignoring the residential market.[8] The report also shows that about 60 percent of CLEC local telephone lines provide service to medium and large business, government and institutional customers, compared to 20 percent of ILEC lines for the same category of customers.[9]

The Commission has recognized the competitive distortions that are created by the current system of implicit subsidies and below-cost residential local prices:

> [E]fforts to sustain implicit universal service support in a competitive environment could encourage business decisions contrary to the purpose of high-cost support **. . . .** For example, competitors may be more likely to target high-revenue business customers in low-cost urban areas where incumbent LECs are charging rates significantly above costs, while foregoing opportunities to serve lower-revenue residential customers in

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[8] ***See*** FCC Report, ***Local Telephone Competition: Status as of December*** *31,* ***2000,*** at Table 2 (May 21,2001).

[9] ***Id.***

> high-cost rural areas where incumbent LECs are charging artificially low rates because of implicit support flows."

Despite acknowledging the problem, the Commission has done very little to address the issue of implicit subsidies during the past five years and, instead, has deferred the issue to the states. Rather than tackle the problem directly, regulators have attempted to manufacture competition in the residential market by forcing ILECs to lease their facilities below actual costs.

This has led to a number of predictable consequences that are simply making the problem worse. First, because residential local prices remain below cost, competition for residential customers has developed more slowly than it should and could have. Second, because the ILECs' wholesale prices remain below cost, facilities-based competition has developed more slowly than it should and could have. Not surprisingly, some CLECs (such as AT&T) have sought to exploit the situation by arguing that the way to stimulate greater competition for residential customers is to further reduce wholesale prices. These additional wholesale reductions would merely provide additional subsidies that CLECs could use to attack the business market. The reality is that facilities-based competition in the residential market will never materialize on a widespread basis as long as prices for residential local service are not self-supporting.

B. Erosion of Universal Service Support

The Commission's failure to address the problem of implicit subsidies, coupled with the competitive environment created by the 1996 Act, has resulted in the rapid erosion of universal service support. Eliminating carrier access charges as part of a

[10] ***Ninth Universal Service Order,*** 14 FCC Rcd at 20441-20442.

transition to bill and keep would only accelerate that erosion. As previously discussed, federal and state regulators have long relied on a complex web of implicit subsidies to support below-cost prices for local residential services. Congress and the Commission have recognized that "[t]hese types of implicit subsidies cannot be sustained, however, in the competitive markets for telecommunications services envisioned by the 1996 Act."" Thus, Congress enacted Section 254, which provides that federal and state universal service mechanisms must be "specific, predictable and sufficient" in order to preserve and advance universal service.[12]

It is inevitable that, in a competitive market, ILECs that are dependent on switched access prices and business service prices as sources of implicit subsidies will lose customers to competitors that do not need to subsidize below-cost services.[13] It also is inevitable, as the Commission has recognized, that subsidies distort business decisions by competitors, driving them to target high-revenue business customers in low-cost areas and to ignore residential customers in higher-cost areas where ILECs are charging below-cost prices.[14] This scenario is unsustainable. As ILECs lose low-cost, high-revenue customers to competitors or reduce their prices to stem such loses, the implicit support

[11] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Intercarrier Compensation for ISP-Bound Traffic*, CC Docket Nos. 96-98 and 99-68, Order on Remand and Report and Order, FCC 01-131, at ¶ 4 (rel. April 27,2001) *(ISP Intercarrier Compensation Order), appeals docketed,* Nos. 01-1218 et al. (D.C. Cir. May 17,2001).

[12] 47 U.S.C. § 254(b)(5).

[13] *Ninth Universal Service Order,* 14 FCC Rcd at 20441.

[14] *Id.* at 20441-20442.

for residential services necessarily disappears.[15] SBC has been experiencing firsthand the problem of eroding implicit subsidies, and it urges the Commission in the strongest terms to address this problem. Reforming intercarrier compensation mechanisms would not result in efficient rules if ILEC prices are not priced efficiently in the first instance, and efficient pricing is not possible unless implicit subsidies are eliminated.

Unfortunately, the Commission's implementation of the 1996 Act has only increased the stress on the universal service system. In particular, the Commission added more than $2 billion annually to the universal service system through the establishment of the schools and libraries fund. Yet the Commission also decided to keep the high-cost fund approximately the same size, regardless of the amount of explicit funding that is actually needed.

The Commission also has taken billions of dollars of implicit support out of the system without substituting adequate explicit universal service support mechanisms. Since 1996, the Commission has forced more than $9.5 billion in interstate access charge reductions industry-wide through its price cap regulations, which does not include revenues that have been lost due to competition or voluntary price reductions. At the same time, the Commission has permitted only modest increases in end user prices (*i.e.*, increases in the federal Subscriber Line Charge) to make up for these reductions. The Commission also has established an explicit, fixed $650 million fund to replace some of the implicit support that is being lost as a result of switched access reductions, but that

[15] ***Id.*** Each customer that an ILEC loses to a competitor results in the loss of implicit subsidy revenues from interstate and intrastate switched access charges, common line charges, toll services and vertical features.

amount is not nearly enough to replace implicit subsidies from the ILECs' prices for switched access and business services.

The Commission has exacerbated the problem by failing to reform its universal service funding rules to reflect technological changes. Although the Commission acknowledged three years ago that certain Internet-based services such as Internet telephony could be characterized as telecommunications services, it has not taken any action to include such services in the contribution base for the federal universal service fund.[16] Likewise, the Commission has yet to act on two federal court decisions holding that the broadband service offerings of cable operators are telecommunications services, which would mean those services should be included in the universal service contribution base.[17] Thus, the universal service obligation is not being applied in a fair and competitively neutral manner.

C. Regulatory Arbitrage Problems

As the Commission recognized in the NPRM, the existing intercarrier compensation rules have created a number of significant arbitrage issues that must be addressed.[18] A major problem is that the compensation rules that apply in any particular case depend on whether the carrier is an ILEC, CLEC, IXC or CMRS provider, and whether the service is classified as local versus long-distance, intrastate versus interstate,

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[16] *See Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Report to Congress, 13 FCC Rcd 11501, 11508 (1998).

[17] *Federal-State Joint Board on Universal Service et al.*, CC Docket Nos. 96-45 et al., Notice of Proposed Rulemaking, FCC 01-145 (rel., May 8,2001).

[18] *NPRM* at ¶ 11.

and basic versus enhanced.[19] This complex system of intercarrier compensation rules creates opportunities for regulatory arbitrage because of the inconsistent manner in which similar carriers and services are often treated.

The most egregious example of regulatory arbitrage has been CLECs seeking ISP customers with high volumes of one-way traffic in order to generate billions of dollars of reciprocal compensation payments.[20] SBC detailed the harmful effects of this arbitrage problem at length in the *ISP Intercarrier Compensation* proceeding, and it will not repeat that discussion here. However, the Commission itself has recognized the harmful effect that ISP regulatory arbitrage has had in the marketplace. For example, the Commission found that the record in the *ISP Intercarrier Compensation* proceeding "strongly suggests that CLECs target ISPs in large part because of the availability of reciprocal compensation payments" and that some have even engaged in fraudulent schemes to generate additional Internet traffic.[21] The Commission concluded that the application of its reciprocal compensation rules to ISP-bound traffic has created market distortions and undermined the operation of a competitive market.[22] In addition, the Commission recognized that, as long as its intercarrier compensation regime fails to reward efficiency and produces retail prices that do not reflect the costs of providing service, it will continue to constitute a barrier to sustainable competition.[23] While the Commission

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[19] *Id.* at ¶ 5.

[20] *Id.* at ¶ 11.

[21] *ISP Intercarrier Compensation Order* at ¶ 70.

[22] *Id.* at ¶ 71.

[23] *Id.*

adopted a transition mechanism to mitigate the impact of ISP reciprocal compensation, it also acknowledged that a permanent solution is needed.[24]

Another type of arbitrage is created by applying different regulatory treatment to functionally similar services. This disparate regulatory treatment enables (indeed encourages) competitors and customers to design services for the express purpose of avoiding payment of the ILECs' switched access charges. For example, a service that is classified as an "enhanced service" can avoid switched access charges even when, as in the case of IP telephony, it closely resembles traditional circuit-switched voice service. The fact that IXCs must pay access charges to a LEC that originates a long distance call, while an ISP that provides IP telephony does not, "gives the provider of IP telephony an artificial cost advantage over providers of traditional long distance services" and erodes ILEC switched access revenues.[25] Recent marketplace developments such as AT&T's multi-billion dollar investment in Net2Phone (a leading provider of IP telephony) and Microsoft's plan to bundle IP voice functionality in its upcoming Windows XP software demonstrate that IP telephony services have the potential to become a widely available mechanism for bypassing long distance and switched access charges.[26]

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[24] ***Id.*** at ¶¶ **6-7**

[25] *NPRM* at ¶ 12.

[26] In March, a consortium led by AT&T announced that it would invest $1.4 billion for a **39%** interest in Net2Phone. AT&T Chairman and CEO Michael Armstrong explained the investment by stating that "Net2Phone has established itself as the Internet's very own phone company." **S.** Fridman, *AT&T-Led* Consortium Acquires Major Stake in *Net2Phone*, Newsbytes, Mar. 31, 2000. In addition, Microsoft has announced that its new Windows XP operating system, which is scheduled to become commercially available on October 25 of this year, will include a computer-based telephony feature that may compete with traditional telecommunications service and offer features such as

There also are arbitrage opportunities created by the different pricing rules that apply depending on the type of traffic (*e.g.*, wireless versus wireline) and the jurisdiction of the traffic (*e.g.*, interstate switched access versus intrastate switched access). For example, a customer may misreport the percentage of interstate usage on its switched access circuits to obtain the benefit of a cheaper intrastate or interstate rate. In the most extreme cases, customers have resorted to fraud by "stripping off' or suppressing calling party number information, and routing the call in a manner that disguises the jurisdictional nature of the traffic.

Yet another arbitrage problem is CLECs that are effectively reclassifying what is functionally equivalent to a long distance call as a local call. In a virtual FX arrangement, a CLEC assigns its customers (typically ISPs) local central office codes associated with the rate center of the calling party (ILEC customer), rather than the rate center of the called party (CLEC customer). This causes interexchange traffic from the ILEC's end user to the CLEC's end user to appear as if it is local traffic.[27] When the ILEC's end users call a CLEC end user who is served by a "virtual FX" arrangement, they are able to bypass applicable toll charges. In addition, when the CLEC does not have a POI in the local exchange from which the call originates, the ILEC may be required to transport the call to the CLEC's distant POI.

Caller ID and voice mail. J. Markoff, *Microsoft Is Ready to Supply a Phone in Every Computer,* N.Y. Times on the Web, June 12,2001.

[27] Many ILECs offer an FX service, but there are significant differences. An ILEC's FX customer (*i.e.*, the called party) pays for a business line in the local exchange of the calling party and transport charges to reach its remote premises. These charges offset the toll charges that are not collected from the calling party.

The Commission should *immediately* issue a clarification that a CLEC may not offer its customers an arrangement that reclassifies ILEC long distance calls as local calls, unless the CLEC provides the transport between the calling party's network and its POI or pays any applicable toll charges. Compliance with these rules should be a prerequisite to the use of numbering resources. There is no reason for the Commission to wait until it implements bill and keep to address the misrepresentation of long distance calls using virtual FX arrangements.

D. Point of Interconnection Disputes

The current rules have led to some difficult interconnection disputes. In particular, as the Commission noted in the *NPRM*, carriers have had disputes about which carrier should bear the cost of providing transport to and from a single POI in a LATA or in an MTA (in the case of CMRS providers).[28] Some CLECs have claimed that an ILEC should be required to provide free transport to a single POI, regardless of the size of the ILEC's local calling area. SBC understands why CLECs would advocate this position. But if the Commission were to implement such a rule, CLECs would have greatly diminished incentives to build their own networks – a CLEC would have no reason to construct its own facilities if an ILEC were required to carry its traffic for free. The fact that ILEC end user charges for local service typically are flat-rated and do not provide any recovery for this additional transport obligation only compounds the problem.

SBC and other ILECs have taken the position that they are entitled to be compensated for the additional cost of transporting traffic beyond the local exchange area

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[28] *NPRM* at ¶ 112.

to a single POI in a LATA.[29] A number of states have agreed with this position.[30] Nevertheless, some CLECs and CMRS providers continue to dispute the issue.

IV. SBC's Comprehensive Plan for Intercarrier Compensation, End User Pricing and Universal Service Reform

SBC's response to the *NPRM* attempts to accommodate the future marketplace three to four years from now, when the Commission's intercarrier compensation reforms will likely be implemented. Many analysts and commentators are predicting the "death of distance," which means there will be little, if any, difference between local and long distance traffic. In addition, SBC and the other BOCs presumably will have received regulatory approval to provide long distance services throughout their traditional territories by that time. It also appears that the Commission is unlikely to regulate new technologies such as IP telephony to the degree it regulates the circuit-switched network. Given these likely developments, the Commission must eliminate implicit subsidies and implement a uniform bill and keep regime in order to achieve a competitively neutral regulatory regime that avoids the problems created by the current rules.

SBC proposes a comprehensive reform plan that is comprised of three components: (i) a proposal to replace implicit subsidies with explicit recovery at the interstate and intrastate level; (ii) a bill and keep proposal for intercarrier compensation; and (iii) pricing flexibility for retail and wholesale services. This plan places a priority

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[29] *Id.*

[30] *See, e.g., Petition of Southwestern Bell Telephone Company for Arbitration with AT&T Communications of Texas, L.P., TCG Dallas, and Teleport Communications, Inc. Pursuant to Section 252(b)(1) of the Federal Telecommunications Act of 1996,* Docket No. 22315, Order Approving Revised Arbitration Award at *2-6* (Texas PUC March 14, 2001).

on the principles of simplification, reduced regulation (with a glide path to full deregulation), explicit and sustainable universal service support, efficiency for incumbents and competitors, and compatibility with technological changes. Due to the continued growth of regulatory arbitrage and development of new technologies and services, SBC urges the Commission to address implicit subsidies and universal service reform immediately, so that bill and keep can be implemented by July 2005.[31]

A. Proposal to Replace Implicit Subsidies With Explicit Recovery

Prior to implementing a uniform bill and keep regime, the Commission must replace implicit subsidies with explicit recovery. This involves both residential local telephone service pricing reform and universal service support reform that establishes an affordability standard. The Commission cannot implement bill and keep without ensuring that end user prices are not reliant on implicit subsidies from carrier access charges and that universal service support is available to maintain affordable end user prices in a bill and keep environment.

The Commission has consistently stated that it intends to address the issue of implicit subsidies that provide support for below-cost prices for residential service.[32] Obviously, the elimination of interstate and intrastate switched access charges as part of

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[31] As discussed further below, an implementation date of July 2005 gives the Commission and the states time to effectuate the transition to bill and keep, which must include residential local service pricing reform and universal service reform. It also corresponds to the end date of the CALLS plan. *NPRM* at ¶ 97.

[32] *See, e.g., Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Report and Order, 12 FCC Rcd 8776, ¶ 8785 (1997*), aff'd in part, rev'd in par and, remanded Texas Office of Pub. Util. Counsel v. FCC,* 183 F.3d 393 (5th Cir. 1999), *cert. granted sub nom. GTE Serv. Corp. v. FCC,* 530 US 1213 (2000), *cert. dismissed 53*1 US 975 (2000); *see also Ninth Universal Service Order,* 14 FCC Rcd at 20435 n.9.

bill and keep would eliminate an important source of implicit subsidies, which would only accelerate the erosion of universal service support that already is occurring. Indeed, by the time bill and keep is implemented, most of the remaining implicit subsidies will have eroded due to competitive losses and price reductions resulting from competitive pressure. Therefore, instead of attempting to identify the amount of explicit support needed to replace implicit subsidies from various sources such as toll charges, interstate and intrastate access charges, vertical services, business services and averaged prices, the Commission should focus on increasing residential service prices to levels that are self-supporting. Specifically, the Commission should immediately initiate a proceeding to establish inducements for states to establish residential pricing structures that allow prices for residential local service to be set at levels that are self-supporting without reliance on implicit subsidies, either from other services or through statewide averaging.[33] The Commission also should establish a timeline for the transition away from implicit subsidies to explicit recovery.

As a procedural matter, the Commission should address implicit subsidies and universal service support reform as part of its obligation to comply with the Tenth Circuit's remand in *Qwest v. FCC*. In that case, the court reviewed the Commission's *Ninth Universal Service Order* in the universal service proceeding and concluded that the Commission had not explained how the current amount of universal service funding is

[33] Once the Commission has implemented residential pricing reform, it should revisit its pricing policies for unbundled network elements and discounted resale services purchased pursuant to Section 251(c). Specifically, the Commission should stop underpricing the ILECs' wholesale products in a futile attempt to stimulate local competition and remove the disincentive for facilities-based competition caused by these artificially low prices.

sufficient.[34] On remand, the Commission is required to "develop mechanisms to induce adequate state action" to implement the statutory goals of universal service and to "explain further its complete plan for supporting universal service."[35] SBC's proposal for eliminating implicit subsidies and reforming universal service offers a comprehensive solution that addresses the very issues remanded by the Tenth Circuit.

SBC recognizes that a transition period is needed to give states time to address the difficult issues of implicit subsidies and universal service reform. Many states, either through state statute or regulation, have capped local service prices. These price restrictions are plainly incompatible with a shift from implicit subsidies to explicit recovery, and from intercarrier compensation to bill and keep. The Commission already has given the states more than five years to address the issue of implicit subsidies, and there is no reason why any state should be given more than four additional years to come into compliance with the universal service requirements of Section 254. States should be required to immediately address the statutory and regulatory changes necessary to comply with the Act and to prepare for the implementation of bill and keep.

In addition to addressing implicit subsidies, the Commission should conduct a fundamental reexamination of universal service funding mechanisms. The purpose of this endeavor would be to establish a comprehensive plan for universal service that complies with the Tenth Circuit's remand. SBC urges the Commission to go beyond its traditional cost-based approach to universal service and consider whether the net effect of residential local service pricing reform and universal service support reform makes

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[34] *Qwest v. FCC*, 2001 U.S. App. LEXIS 17044, at * 3.

[35] ***Id.*** at *31, 34.

quality services available at "just, reasonable, and affordable rates," as required by Sections 254(b)(1) and 254(i). With the exception of Lifeline customers, universal service support should be limited to those residential customers who reside in geographic areas in which prices would be unaffordable in the absence of such support. Non-Lifeline customers in all other areas should pay unsubsidized prices for telephone service.

SBC believes that "affordability" represents an end user's ability to bear the cost of service relative to household income. Universal telephone service prices represent a household expenditure, just as cable television prices, automobile prices, food prices and prices paid for entertainment are household expenditures. Other types of household expenditures should be reviewed to determine a household expenditure level for universal services that would be considered "affordable".[36] Prices that exceed this affordability threshold for a given geographic area would be considered unaffordable and would trigger the availability of explicit universal service support. Universal service support for financially disadvantaged individuals should be addressed by the Lifeline mechanism and increased if necessary.

Recovery of universal service support should be generated through a percentage-based surcharge applied to interstate retail revenues associated with traditional retail telecommunications services, cable modem services, cable telephony services and Internet services (since ISPs rely on telecommunications to provide Internet services). The Commission should ensure that, as new technologies and services are introduced in

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[36] An affordable household expenditure level could be expressed as a percentage of median household income (median household income would be averaged over a pre-determined geographic area).

the marketplace, the universal service support obligation is applied consistently and fairly. Expanding the funding base in this manner acknowledges convergence and ensures competitive and technological neutrality. The Commission also should work with the states to implement explicit intrastate universal service support funding mechanisms that operate in the same manner as the federal mechanism and effectively mirror it. This would reduce the opportunity for gaming because providers no longer would be able to avoid a federal universal service funding obligation by characterizing revenues as intrastate.

B. Bill and Keep Proposal

1. Bill and Keep Implementation

SBC supports the Commission's proposal to extend bill and keep to all local, wireless and Internet telecommunications traffic that currently is subject to the Commission's reciprocal compensation rules. However, the Commission needs to ensure that ILECs have an opportunity to recover their costs from end users. The Commission can no longer ignore the fact that the ILECs' existing local end user prices often do not provide recovery for the costs associated with providing transport between two networks in a bill and keep environment.

The Commission also has proposed to replace interstate and intrastate access charges with bill and keep. Such a proposal raises much more difficult end user recovery issues, and cannot be addressed solely as an intercarrier compensation issue.[37] As previously discussed, carrier access charges are an important source of implicit subsidies.

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[37] For example, unlike local calls, a bill and keep regime for switched access charges will involve implementing end user recovery for call origination, as well as call termination.

Therefore, the Commission cannot eliminate carrier access charges without ensuring that there are end user recovery mechanisms in place.

In order to eliminate existing arbitrage opportunities and avoid creating new arbitrage problems, it is critical that the transition to bill and keep be mandatory for the exchange of all telecommunications traffic between a LEC network and another carrier's network (including transport arrangements) in all states.[38] Bifurcation would create additional arbitrage opportunities. For example, bill and keep must be implemented for interstate and intrastate switched access services at the same time. If the Commission were to implement bill and keep only for interstate services, there would be rampant regulatory arbitrage to avoid intrastate switched access charges. Thus, the Commission must implement a uniform bill and keep structure to achieve a competitively neutral regulatory regime that avoids many of the problems created by the current rules.

2. Bill and Keep Rules

SBC generally agrees with the central office bill and keep (COBAK) proposal set forth in Patrick DeGraba's OPP Working Paper No. 33, but with some modifications.[39]

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[38] In the *NPRM*, the Commission stated that it does not contemplate adopting new rules governing interconnection arrangements that are not regulated, such as CLEC-to-CLEC, IXC-to-IXC, CMRS-to-CMRS and CMRS-to-IXC arrangements. *NPRM* at n.2. To the extent any of these arrangements involve the exchange of traffic with a LEC network – for example, CMRS-to-CMRS traffic that transits a LEC network – it is essential that they be included in the Commission's bill and keep rules. The fact that CMRS providers and CLECs would be subject to the end user recovery requirement and default transport rules does not mean these carriers would be subject to rate regulation.

[39] *See* Patrick DeGraba, *Bill and Keep at the Central Office as the Efficient Interconnection Regime* (Federal Communications Commission, OPP Working Paper No. 33, Dec. 2000).

A glossary of definitions for key terms used in SBC plan is attached.[40] SBC proposes the following three bill and keep rules:

> **Rule 1:** Service providers must recover network access costs from their own end users.[41] The term "network access" includes the loop, end office switching, transport to complete intra-network calls, and network-to-network (N2N) transport to reach the called party.

The requirement that service providers must recover network access costs from their own end users would not be subject to negotiation.

While the network access recovery rule would not be subject to negotiation, service providers would be allowed and encouraged to negotiate the N2N transport arrangements necessary to interconnect their respective networks. If negotiations fail, then the following N2N transport default rules apply:

> **Rule 2:** The calling party's retail service provider for transport is responsible for the N2N transport between the end office serving the calling party and the end office serving the called party, except as provided for in Rule 3 below.[42] When

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[40] See Attachment 1.

[41] As long as ISPs continue to be treated like end users for access purposes, they will be responsible for the cost of network access, but not for the cost of transport used to reach the ISP.

[42] The term "end office" is defined as the building location where the loop facility (or its equivalent) terminates and end office switching occurs. An end office also represents the final point of interconnection to which the calling party's service provider can extend its network-to-network transport facilities without actually providing network access functions to the called party. In order to preserve functional equivalency, a CMRS provider's mobile switching center (MSC) would be treated as an end office. A host end office serving remote switching units also would be considered the end office for the exchange of traffic destined for end users served by the remotes.

the calling party has separate retail relationships with a local service provider and a long distance service provider, this transport rule applies to the local service provider in the case of local traffic and the long distance service provider in the case of long distance traffic.

Rule 3: When the end office serving a called party is not located in the called party's home Access Service Area (ASA), the called party's service provider must establish a POI within the called party's home ASA for the exchange of traffic. Initially, LATAs would serve as the ASAs. The calling party's retail service provider for transport is responsible for the N2N transport between the end office serving the calling party and the designated POI in the called party's ASA. The called party's service provider is responsible for transport between the POI and the end office serving the called party

Attachment 2 hereto consists of illustrative diagrams showing the application of SBC's proposed rules.

It is important to note that the default transport rules do not impose any requirements on the size of a service provider's service territory – the rules simply allocate the N2N transport responsibility in a consistent manner for all traffic that a service provider agrees to transport on behalf of a calling party (*e.g.*, local, long distance or both). Moreover, under the default transport rules, service providers would be allowed to negotiate alternative arrangements that allocate the costs of transport or the responsibility for transporting traffic in a manner that differs from the default rules.

The default rules do not impose discrete requirements on carriers to provide transiting services or tandem switching, or to otherwise act as wholesale transport providers on behalf of other carriers.[43] SBC is strongly opposed to a bill and keep regime that would require ILECs to serve as the low-cost provider of transport for all other carriers. Such a result would curtail the incredible growth of competitive transport that has occurred since 1996.

SBC's default rules are similar to DeGraba's COBAK rules, but there are some important differences. The COBAK proposal established a modified transport rule for long distance calls traversing three networks:

> "Rule 2A: For interexchange calls, the calling party's local network is responsible for delivering the call to the point of presence of the calling party's interexchange carrier; the calling party's interexchange carrier is then responsible for delivering the call to the called party's central office."

SBC agrees with DeGraba that the default rules must account for the fact that an end user may have a retail relationship for transport services with more than one service provider. However, SBC's default rule for these types of interexchange calls differs from the COBAK rule. Specifically, SBC's rule applies COBAK default Rule 2 consistently to the service provider that has the retail relationship for transport, rather than requiring the calling party's local service provider to assume a portion of the transport obligation associated with the long distance service provider's retail relationship.[44] Thus, SBC's rule operates in the same manner regardless of whether the calling party's retail

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[43] SBC agrees with Qwest that the bill and keep rules should not apply to transport providers that do not have a relationship with an end user (*e.g.*, a transiting carrier or wholesale tandem switching provider). See *NPRM* at ¶ 71.

[44] The COBAK default Rule 2 requires the ***callingparty's network*** to be responsible for the cost of transporting calls between the calling party's central office and the called party's central office. See OPP Working Paper No. 33 at ¶ 5.

relationship with a transport service provider is for local calls, long distance calls, or both.

SBC believes it is more appropriate for the transport obligation to operate uniformly for all retail transport providers associated with call origination, rather than to treat IXCs like the network that will terminate a call.[45] IXCs have purchased access facilities from their points of presence (POPs) to ILEC end offices and/or tandem switches based on their own needs and design specifications (*e.g.*, capacity, premises location and facility type).[46] Accordingly, IXCs should retain the responsibility for transporting long distance calls. Moreover, a flashcut transition to a bill and keep regime whereby ILECs would be responsible for transport from the calling party's end office to the IXC's POP could encourage inefficient interconnection arrangements, to the extent an IXC could consolidate and relocate its POPs only for originating traffic in order to minimize its own transport costs. The result would be unnecessary network churn and stranded facilities. SBC's proposal, in comparison, incents IXCs to deploy POPs in a manner that minimizes transport costs between the calling party's end office and its POP.

SBC's bill and keep rules also deviate from the COBAK proposal when the called party's service provider has elected to locate the end office serving the called party in a distant geographic area. Typically, this will occur when a service provider has made a decision to serve a large geographic area with a single switch. Under SBC's proposal,

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[45] For inter-network calling, the carrier that terminates a call typically does not have a retail relationship with the calling party.

[46] The Commission's switched access collocation orders have resulted in transport being unbundled from the ILECs' switched access services. As a result, many IXCs have replaced ILEC transport with their own facilities or competitive transport.

absent an agreement to the contrary, the called party's service provider is required to establish a POI in the called party's home **ASA.** This rule is preferable to the COBAK proposal because it encourages carriers to build out their networks and prevents them from unfairly transferring transport costs to the calling party's service provider.

SBC's rules reflect a balanced approach by combining a mandatory end user recovery requirement, which is fundamental to a bill and keep regime, with negotiation and default provisions that promote efficient network transport arrangements. SBC's proposal establishes a direct link between a service provider's efficiency and the retail prices it must charge to recover its costs. Service providers should not be permitted to shield themselves from imprudent network investment decisions or from the high costs of operating their networks by shifting network access costs to their competitors.

The desired outcome of SBC's proposal is a negotiated network-to-network transport arrangement for call termination purposes that avoids the need for regulatory intervention. **A** negotiated interconnection arrangement should produce an equitable, yet efficient, inter-network design because the parties are permitted to balance their individual network needs with efficient engineering principles. Further, the default rules should promote regulatory certainty because arbitration should not be required if transport negotiations fail. Service providers are free to design the transport architecture, as well as the service quality standard for their interconnection trunk groups – the default rules promote negotiated outcomes because they do not attempt to specify the efficient solution.

C. Pricing Flexibility Proposal

The implementation of a uniform bill and keep regime would constitute a significant restructuring of ILEC recovery from carriers to end user. Not only would interstate and intrastate carrier access charges for end office switching and common line charges be eliminated, but ILECs also would incur additional N2N transport costs that are not covered by existing local service prices. Therefore, under SBC's plan, bill and keep must be accompanied by pricing reforms that permit recovery of all end office switching, common line charges and N2N transport costs from residential and business end users.

The Commission has various options for ensuring that end user recovery mechanisms are established as part of the implementation of bill and keep. Pursuant to Sections 251(g) and 201, the Commission itself is responsible for replacing interstate switched access charges with comparable recovery from end users. Such a shift would need to be revenue neutral for LECs that currently depend on the revenue from carrier access charges. One way to ensure end user recovery would be to replace carrier access charges for end office switching and common line charges with an increase to the existing Subscriber Line Charge. However, SBC believes the better solution would be to give all carriers pricing flexibility in obtaining end user recovery. One of the primary benefits of moving to a bill and keep regime is to avoid problems caused by regulators setting prices, and the Commission's objective should be to get out of the price-setting business as soon as possible.

With respect to intrastate services, the Commission also should establish general requirements for state end user recovery mechanisms. At a minimum, the ILECs must be allowed to increase residential local service prices so they are self-supporting with no reliance on implicit subsidies. States would continue to have the authority to regulate prices for intrastate services, provided that their pricing structures are consistent with the statute and the Commission's implementing regulations. Once again, carriers should have pricing flexibility in determining how to replace intrastate access charges with end user recovery.

In a bill and keep environment, CLECs and other competitors will be able to respond to market forces by implementing calling and pricing plans that meet the needs of end users. Therefore, it is critical that ILECs be given significant pricing flexibility for both network access services and transport services. In particular, ILECs should have the same pricing flexibility as other carriers to implement capacity-based pricing, package pricing and other pricing plans that optimize customer choice. This flexibility also should include the ability to implement zone pricing plans as needed to reflect cost differences in the provisioning of network access services.[47]

Moreover, existing price regulations based on traditional local exchanges are incompatible with the new bill and keep rules. For example, ILECs must have the ability to recover the cost of transporting traffic outside the local exchange to another ILEC, a CLEC or a wireless provider. In evaluating the impact of bill and keep on end user prices, it is important to consider the overall impact on end user bills and not focus on one element, such as local service. Given the necessary pricing flexibility, ILECs will have the ability to offer customers a variety of calling plans that may prove more efficient and cost effective than their existing alternatives.

[47] ***See,*** *e.g.*, 47 C.F.R. § 69.152(q) (rules for geographic deaveraging of End User Common Line Charges); 47 C.F.R. § 69.123(b) (allowing price cap LECs to establish density zones for special access and switched transport).

V. The Commission Has the Authority to Address the Problem of Implicit Subsidies and to Implement a Uniform Bill and Keep Regime

The Commission has the authority to implement each component of SBC's comprehensive reform plan. In particular, the Commission has the authority and the obligation, as the Tenth Circuit recently held, to establish inducements to ensure that states end their reliance on implicit subsidies for recovery of the costs of providing residential local telephone service. It also has the authority to implement a uniform bill and keep regime for both interstate and intrastate traffic. Moreover, a mandatory bill and keep regime appears to be consistent with the reciprocal compensation provisions of the Act, provided that the Commission ensures there are end user recovery mechanisms in place.

A. The Commission Must End Reliance on Implicit Subsidies and Implement Universal Service Support Reform

The Commission has the authority, but also the obligation, to address the broader issue of ending reliance on implicit subsidies to maintain below-cost residential local service prices. Section 254(e) provides that universal service support should be "explicit and sufficient." The Fifth Circuit has held that "the plain language of Section 254(e) does not permit the FCC to maintain implicit subsidies,"[48] and it recently determined that the Commission could not even *allow* carriers to recover universal service costs through access charges because such recovery constituted an unlawful implicit subsidy.[49] While the Commission has consistently stated its intent to address the difficult issue of implicit

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[48] *Texas Office of Pub. Util.* **Counsel** *v. FCC,* 183 F.3d 393,425.

[49] *Comcast Corp. v. FCC,* 250 F.3d 931,938-39 (5th Cir. 2001).

subsidies,[50] it has done little to replace implicit subsidies with explicit recovery during the past five years.

Rather than addressing the issue piecemeal by simply replacing intercarrier compensation with end user recovery, the Commission should require that states end their reliance on implicit subsidies as the primary source of universal service support. Many of the universal service requirements of Section 254 apply directly to the states. As the Tenth Circuit recognized in *Qwest v. FCC*, the 1996 Act "clearly contemplates a partnership between federal and state regulators to support universal service."[51] Specifically, Section 254(b)(5) provides that there should be "specific, predictable and sufficient" federal and state mechanisms to preserve and advance universal service,[52] and Section 254(f) provides that a state may adopt regulations not inconsistent with the Commission's rules to preserve and advance universal service.[53] Of particular relevance to this proceeding, Section 254(i) provides that "the Commission and the States should ensure that universal service is available at rates that are just, reasonable and affordable."[54] SBC believes the Commission has the authority under Section 201(b) to establish inducements to achieve the statutory goals of 254 and to eliminate state pricing structures that are incompatible with the nationwide implementation of universal service reform.

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[50] *See, e.g.*, *Ninth Universal Service Order*, 14 FCC Rcd at 20435 n.9.

[51] *Qwest v. FCC*, 2001 U.S. App. LEXIS 17044, at * 29.

[52] 47 U.S.C. § 254(b)(5).

[53] 47 U.S.C. § 254(f).

[54] 47 U.S.C. § 254(i).

The Tenth Circuit's decision in *Qwest* v. *FCC* stands for the proposition that the Commission has an obligation to ensure that states take the necessary action to achieve the requirements of Section 254. Among other things, the court held that the Commission improperly "base[d] its policies on the principle that there should be sufficient state mechanisms to promote universal service" without "ensur[ing] that these mechanisms exist."[55] While the court recognized that it was probably necessary for the Commission to rely on state action to help implement universal service, the court nevertheless held that the Commission could not simply *assume* that states will act on their own to preserve and advance universal service.[56] On remand, the Commission is required to "develop mechanisms to induce adequate state action" and to "explain further its complete plan for supporting universal service."[57]

To fulfill this mandate, the Commission should establish the necessary inducements to ensure that states replace implicit subsidies with explicit recovery. The elimination of implicit subsidies and implementation of residential pricing reform are essential components of meaningful universal service reform. Anything less would not "preserve and advance universal service," as required by Section 254(f), and would maintain unlawful implicit subsidies. As previously discussed, both Congress and the Commission have recognized that implicit subsidies are not sustainable in a competitive environment and that regulators cannot continue to rely on implicit subsidies as a source

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[55] *Qwest v. FCC*, 2001 **U.S.**App. LEXIS 17044, at * 27-28.

[56] ***Id.*** at * 30.

[57] ***Id.*** at * 31, 34.